June 2021

Approaches to ESG Investment

Aberdeen Standard Investments

JC3 Joint Committee on Climate Change

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What is ESG?

What is ESG?
ESG refers to Environmental, Social, and Governance factors

- **Environmental** factors include: climate change and decarbonisation, companies' attitude and behavior towards environmental and waste management, pollution, water consumption and efficiency, energy consumption and efficiency

- **Social** factors include: companies' behavior and attitudes towards customers, employees, local communities, and governments, and include topics such as human and labour rights, and corruption

- **Governance** factors include: the forms and dynamics of company ownership, management, performance and incentivisation, fair and equitable treatment of shareholders

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Approaches to ESG Investing

There are many ways to invest responsibly. Typically it is a combination of two areas

CONSIDERING ESG ISSUES WHEN BUILDING A PORTFOLIO (known as: ESG incorporation)			**IMPROVING INVESTEES' ESG PERFORMANCE (known as: active ownership or stewardship)**	
ESG issues can be incorporated into existing investment practices using a combination of three approaches: integration, screening and thematic.			Investors can encourage the companies they are already invested in to improve their ESG risk management or develop more sustainable business practices.	
Integration	**Screening**	**Thematic**	**Engagement**	**Proxy Voting**
Explicitly and systematically including ESG issues in investment analysis and decisions, to better manage risks and improve returns.	Applying filters to lists of potential investments to rule companies in or out of contention for investment, based on an investor's preferences, values or ethics.	Seeking to combine attractive risk-return profiles with an intention to contribute to a specific environmental or social outcome. Includes impact investing.	Discussing ESG issues with companies to improve their handling, including disclosure, of such issues. Can be done individually, or in collaboration with other investors.	Formally expressing approval or disapproval through voting on resolutions and proposing shareholder resolutions on specific ESG issues.

Source: 'What is responsible investment?', PRI, 2021

ESG Investing: an accelerating trend

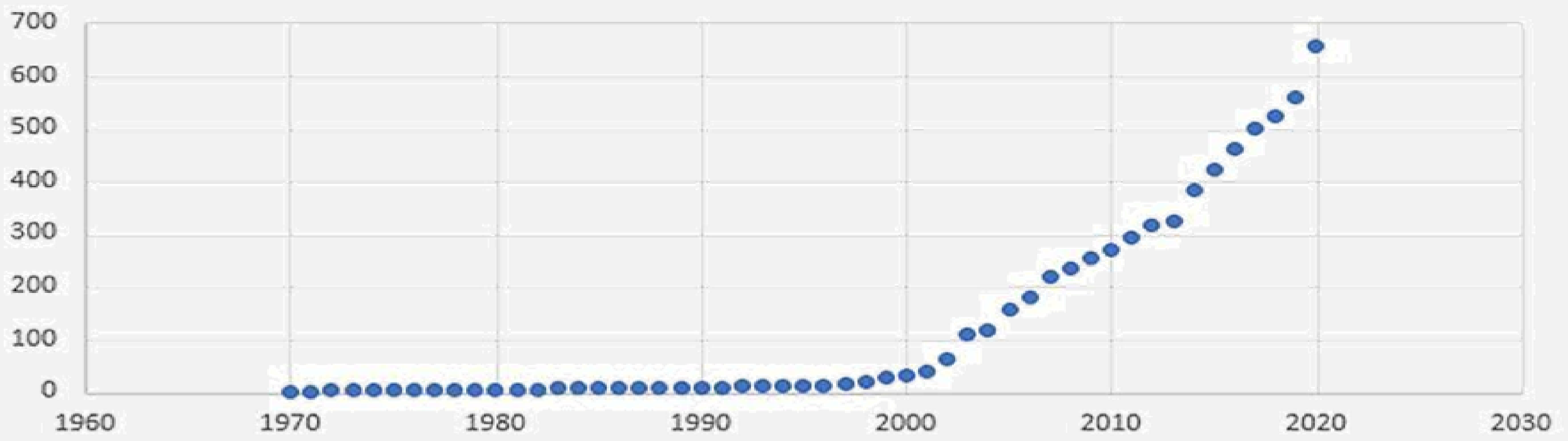
ESG: Quantifying a secular trend
Clients are demanding it

- ESG funds have taken $84 out of every net $100 flowing into equity funds in the last two years, a total of $15.1bn out of $18.1bn
- Globally, the total assets under management of ESG investment products is now above US$1.7 trillion (A$2.2 trillion), according to Morningstar, boosted by an almost 30% jump in the fourth quarter of 2020 alone
- In Asia, according to a report by Cerulli Associates, 62% of asset owners say they seek information about ESG integration from managers, but as yet do not make it a requirement
- More significantly, 69% of respondents chose ESG integration within the investment decision making process

Source: Calastone Global Report, 25 February 2021, Cerulli Associates ‘Responsible Investing in Asia 2020’

Regulation, policy and guidelines
Continues to rise

Cumulative number policy interventions

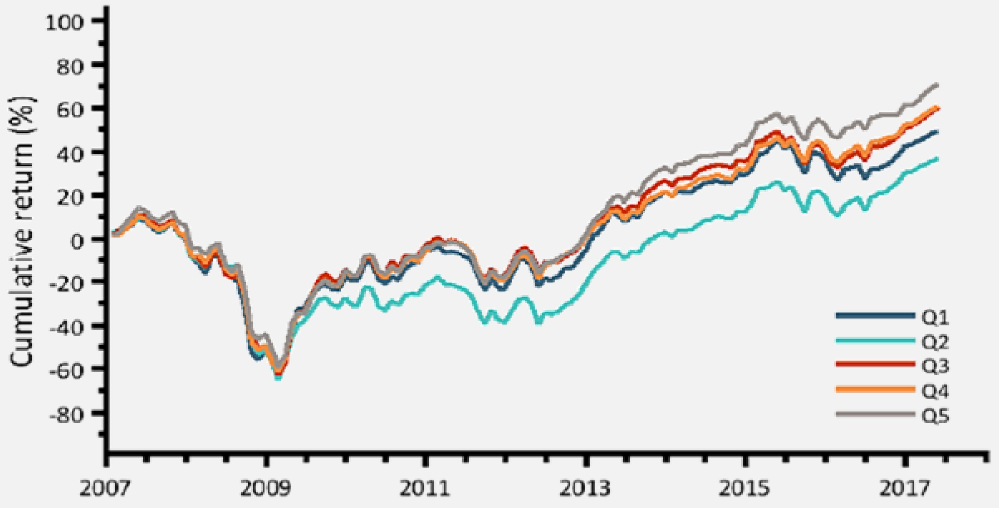


Forecast is offered as opinion and is not reflective of potential performance. Forecast is not guaranteed and actual events or results may differ materially
Source: PRI responsible investment regulation database

Why do investors care?

Historical Performance of ESG Rating Quintiles for World ex US

- MSCI study of stock performance of five ESG score quintiles (Q1 to Q5), with Q1 indicating the companies with the lowest ESG rating and Q5 the highest-rated companies
- 10-year back-test with monthly re-balancing of five ESG quintiles portfolios
- Highest ESG-rated companies' quintile (Q5) performed better over the 10-year period than the other quintiles
- Higher ESG-rated companies outperformed those with lower ratings



Note: Equal-weighted quintiles are formed every month from the non-US constituents of the MSCI World Index. The ranking is based on the MSCI ESG score. Returns are measured in local currency and include dividend reinvestment
Source: MSCI, "FOUNDATIONS OF ESG INVESTING Part 1: How ESG Affects Equity Valuation, Risk and Performance". **Past performance is not a guide to future results**

Integration into investment process

ESG Investment Philosophy

We believe that comprehensive assessment of environmental, social and governance (ESG) factors, combined with constructive company engagement, leads to better client outcomes:

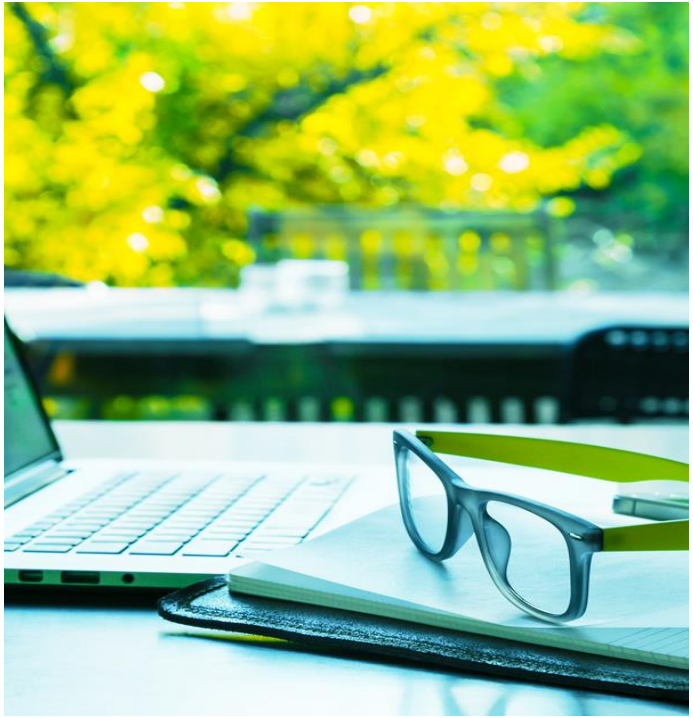
- ESG factors are financially material, and impact corporate performance
- Understanding ESG risks and opportunities alongside other financial metrics allows us to make better investment decisions
- Informed and constructive engagement helps foster better companies, protecting and enhancing the value of our clients' investments

ESG integration

- ESG integration involves the consideration of environmental, social and governance factors alongside other financial metrics

- Stems from a recognition that ESG factors are financially material, and impact corporate performance

- Not just ‘ethics’ or ‘values’…but a way of more fully understanding the risks and opportunities around an investment



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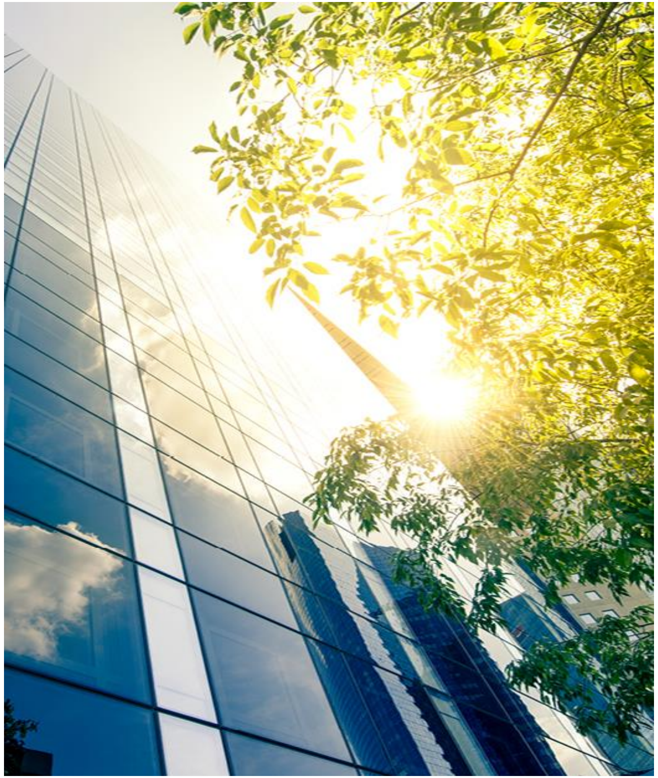
ESG Integration



ESG is a holistic approach to risk assessment …

- Focused on a company's management of its own risks
- Holistic approach – assessing financial and ESG risks together and focusing only on those risks which are material to the company's operations
- Constantly evolving as material risks change over time

…and we believe a source of alpha

- Understanding industry-wide ESG factors can help identify long-term winners and losers
- Particularly true for industries in transition, and those affected by sustainability mega-trends
- Engagement and positive change over time can help build resilience and drive returns

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How do we manage the risks?

Active and engaged shareholders

Pre investment due diligence → **Initiation** → **Engagement** → **Re-evaluation**

Consider

- Ownership structure
- Business strategy
- Management
- Financials
- Corporate governance
- Environmental / social issues

Discuss

- Protect and enhance value
- Communicate concerns on relevant issues
- Establish/build on relationships
- Help to drive change
- Improve internal and external reporting

Review

- Constantly review investment thesis

How we do ESG

Overview of Process

We think ESG factors are financially material, and impact corporate performance

Analyse

- Company's risk management system and its business strategy
- Links between key risks and targets and remuneration
- The incorporation of risk management into the company's strategy and culture

Consider

- Does the company understand its material risks? How is the company managing these risks?
- What is the future of the risk likely to be?
- Has the company considered future trends and business opportunities?

Engage

- Corporate strategy and governance, and capital allocation
- Business risk identification and prioritisation
- Areas of weakness and potential areas for improvements

Source: Aberdeen Standard Investments

Potential ESG issues

Supply chain – relationship with suppliers

- Poor labour practices – modern slavery, child labour etc.
- Environmental practices – pollution etc.
- Food safety
- Sustainable sourcing
- Controversial sourcing

Product liability – relationship with customers

- Product quality and safety
- Threat from disruption (e.g. fintech)
- Cyber security and data privacy
- Changing consumer tastes from social, environmental and demographic change
- Product regulation
- Product responsibility – marketing, appropriate selling etc.

Human capital – relationship with employees

- Health and safety
- Labour relations
- Talent retention
- Corporate culture
- Skill development
- Managing digitalisation
- Human Rights

Corporate governance – relationship with investors

- Board independence
- Remuneration
- Protection for minorities
- Succession
- Transparency

Environmental responsibility – relationship with the natural environment

- Carbon risks – transitional and physical
- Water management
- Waste management
- Energy efficiency
- Pollution and toxic emissions
- Biodiversity

Business responsibility – relationship with society

- Community relations
- Bribery/corruption
- Tax
- Political involvement
- Compliance with legislation and regulation

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Engagement

The Engagement Opportunity

Improving ESG has under recognised alpha potential

- Inconsistent external ratings create an opportunity
- Third party ESG scores are lagging indicators
- Active engagement allows us to take advantage of inefficiencies and identify ESG Leaders and Improvers
- Active engagement can drive positive changes in corporate behaviour, mitigate risk and improve performance
- Engagements produce a more in-depth understanding of a company's management of ESG risks and opportunities than the published KPIs which are relied upon by quantitative scoring mechanisms

"Alpha generation potential is likely greater for fundamental investors who are able to identify ESG improvement stories before they are reflected in scores."

– Bernstein, 20 April 2021

Company Engagement

Change takes trust, time, and tenacity

- Engagement takes **trust** – companies (and investors) need to develop a level of trust and mutual understanding in order for engagement work, meaning…

- Engagement takes **time** – cannot see engagement as a targeted, discrete, and clinical activity. Often single meetings can feel uneventful, meaning…

- Engagement requires **tenacity** – engagement needs to be part of a longer discussion with a company, with points continually (but appropriately) raised in successive meetings

Engagement needs to be part of the investment process, with a focus on performance rather than conformance.

Company Engagement

Some typical examples

Key Risks/Issues	Areas of engagement/potential questions
Capital allocation	• Why do you continue to maintain high levels of cash on the balance sheet? • What are your expectations around capital return? • What is your dividend policy?
Strategy	• Why do you continue to invest in a certain (non-core) segment? • What gives you confidence to operate in a certain segment / geography? • What are your hurdle rates for investment?
Poor labour practices in the supply chain	• What labour standards do suppliers adhere to and how is this monitored? • How extensive is the coverage of supplier audits? • What steps has the group taken to ensure against the use of child labour?
Cyber security	• What is the group's IT governance structure? • What systems are in place to mitigate security lapses, cyber and data breaches? • Has the group ever suffered from a significant cyber attack, data breach or systems failure?

Company Engagement

Our findings

The Good

- Companies increasingly open to discussion
- Increasing reception to ideas for performance improvement, e.g. strategy, capital allocation & return, stock option plans
- Environmental disclosures are improving, albeit from a low base

The Less Good

- Engagement requires relationships, and these take time to build
- Still box ticking activity for many, e.g. substantially similar (and often boilerplate) disclosures for several years
- Less integration of sustainability into strategy than other developed markets

Considerations & Challenges

Considerations & Challenges

- Screening – think about impact.
- Integration – think about structure.
- Engagement – think about performance.

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SG-140621-151253-1